

10 FAQs for Form 1042/1042-S Processing

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If an amount was underwithheld or a required U.S. taxpayer identification number (TIN) is missing, the error will result in the payer being obligated for the under withheld tax plus penalties and interest.

1. We have Form 1042-S records for which we did not withhold the correct amount. What should we record on the Form 1042-S?

Instructions to Form 1042-S and IRS Publication 1187, *Specifications for Filing Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding Electronically*, both state that the amount that was actually withheld must be recorded on Form 1042-S.

Electronic Form 1042-S records must be flagged as correct, overwithheld, or as in this case, underwithheld.

2. How do we pay the underwithheld taxes for these Form 1042-S records?

The amount that should have been withheld must be included in liabilities on the organization's Form 1042 tax return in the period when the income payment was made.

Underwithholding taxes will result in the organization being liable for paying the underwithheld taxes computed on their Form 1042 tax return. These taxes may not be taken as a tax deduction on a for-profit organization's tax return.

3. Will the taxes paid have to be grossed-up?

No, because the underwithheld taxes are the organization's liability.

If, however, your organization agrees to pay the individual's tax, the tax paid must be grossed-up for taxes because the tax paid on behalf of the individual is income to the individual. To gross-up an amount for withholding, divide by one minus the tax rate (e.g., $1 - .30 = .70$).

In this case, the grossed-up income amount and taxes must be recorded on the recipient's Form 1042-S and the taxes must be deposited as Form 1042 taxes for the applicable tax year.

4. What if we withheld the tax but forgot to deposit it?

An organization can still deposit amounts for the prior tax year as long as the organization has not submitted its Form 1042 tax return for the applicable tax year. The deposit can be added to other deposits recorded on line 64 of Form 1042. Such late deposits will be subject to a late deposit penalty.

5. Are we required to refund withheld taxes if the recipient provides a valid Form W-8BEN or Form 8233 with a treaty claim after payment was made and taxes were withheld?

No. The section 1441 regulations allow payers to refund NRA overwithheld taxes in this situation but it is not required.

There is no regulation allowing the refunding of withholding on wages when a Form 8233 is provided after payment and withholding has been made. Some organizations do make such refunds because it makes the employee's tax return preparation easier and eliminates questions for payroll regarding the proper treaty-exempt amount for the year when some of the wages that would have been treaty-exempt, but for a timely form, were subject to wage withholding.

6. Can we refund overwithheld taxes?

IRS rules allow an organization to retain 10 percent of the deposits to use for making refunds of amounts that are overwithheld in that tax year. (See the discussion of "Deposit Requirements" in the Form 1042 instructions.)

7. What if the organization did not retain 10 percent of the deposits?

Also, if the organization will be collecting sufficient withholding from future payments, these amounts may be used to refund overwithheld taxes. In this case, the deposits for the future deposits are reduced by the amount of the tax refund for which a deposit has already been made.

8. What if the organization will not have sufficient future withholding in the tax year from which to refund the overwithheld taxes?

In such a situation, the organization may choose to refund an overwithheld amount out of the organization's own funds and reimburse the organization by reducing any subsequent deposits made for the following calendar year by an amount equal to the amount that was repaid to the recipient. (This is called the "repayment method.")

Since the amount repaid out of the organization's own funds must be shown on Form 1042 (line 63c) for the year of overwithholding, such a refund must be made to the income recipient before the withholding agent files Form 1042 for the calendar year (i.e., by March 15 of the calendar year following the year of withholding).

Because the amount repaid must also be reported on line 11 Form 1042-S for the year of overwithholding, the Form 1042-S record will need to be corrected unless the repayment is made prior to submission of the original Form 1042-S to IRS.

To use this method, an organization must report the correct tax liability on Form 1042 for the period in which the overwithholding occurred. Because the federal tax deposit for the affected period will exceed the amount of the tax liability reported, the

organization's Form 1042 must show an overpayment of tax. (See the instructions for Form 1042.) The organization may choose to have the amount of the overpayment of tax refunded to the organization, or may apply the amount as a credit to reduce the required deposits of withheld tax for the following year.

9. We have a number of records that have missing taxpayer identification numbers. Will these records cause a problem?

According to the IRS, the failure to include a TIN on a record is not an error as long as the correct tax has been withheld (30% or 14%).

However, if a record has an Exemption Code 04 (exemption under a tax treaty) or an Exemption Code 00 with a reduced rate of tax under a treaty, the organization will be liable for the tax on this record at the applicable statutory withholding rate. Generally, the withholding rate is 30%. However, the tax rate is 14% for Income Code 15 (Scholarships and Fellowships) paid to certain recipients in F, J, M, or Q status and 30% for all other recipients.

If the record without a TIN has Income Code 17, 18, or 19, this income is generally employment income which must be reported on Form W-2. The appropriate taxes may be paid for the tax year and reported on the organization's Form 941 employment tax return. The wages must be grossed up for the payroll taxes if the organization is paying the individual's tax.

10. Is there a penalty for failing to include a TIN on a Form 1042-S?

As long as the organization provides the TIN in situations required as described in the Form 1042-S instructions for the applicable tax year, the IRS should not impose a penalty for not having a TIN on such records.

To avoid a penalty for not having a TIN on a Form 1042-S record, the organization must have a record in its files indicating a request for a TIN but that was not provided. Typically, this is an intake form (such as the Foreign National Information Form) in which the TIN information is left blank by the individual completing and signing the form. With such proof, the organization may request abatement of a penalty of failure to include a TIN on an information return.